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SUBJECT: Argentina Economic and Financial Weekly for the week ending May 19, 2006

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Weekly Highlights
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- Venezuela buys another USD 239 million of Boden 2012 bonds.
- GOA runs an ARP 1.5 billion primary fiscal surplus in April -- lower than expected.
- Wheat exporters agree to supply the domestic market to avoid wheat price increases.
- Unemployment fell 1.6 percent y-o-y to 11.4 percent in the first quarter, but increased q-o-q.
- GOA warns oil companies to invest or lose their concessions.
- March monthly economic activity index up 7.7 percent y-o-y - weaker than expected.
- Commentary of the Week: "Obstacles to the 'Argentine Miracle." (Note: there will be no Weekly Report for the week ending May 26 due to American and Argentine holidays. The Weekly Report will be resumed with a bi-weekly special edition on June 2. End Note.]

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Venezuela buys another USD 239 million of Boden 2012 bonds.
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¶1. On May 11, the GOA sold USD 239 million of Boden 2012 (a USD-denominated bond maturing in 2012), for a market value of USD 200 million, to the Government of Venezuela (GOV). The GOA sold the bonds at market prices that translate into a yield of 7.59 percent. With this purchase, the GOV will have purchased Argentine bonds worth USD 1.5 billion (at face value, or USD 1.2 billion at market value) in 2006. In 2005, the GOV purchased USD 1.9 billion of GOA bonds (USD 1.6 billion market value).

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GOA runs an ARP 1.5 billion primary fiscal surplus in April -- lower than expected.
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¶2. The GOA announced a primary fiscal surplus of ARP 1.5 billion in April, below market expectations of ARP 1.7 billion, and well below the ARP 2.2 billion in the same month last year. April's surplus brings the accumulated fiscal surplus for the first four months of 2006 to ARP 6.4 billion, ARP 1.2 billion above the ARP 5.2 billion target for the period. The lower-than-expected April surplus is the result of rapidly rising spending levels -- mainly debt interest payments, transfers to provinces, higher salaries and capital expenditures -- as well as lower revenues due to the extension of the income tax payment deadline to May. Ambito Financiero reported that the April surplus figures were padded by ARP 600 million that the GOA received from the Central Bank (BCRA) in April for profits that the BCRA earned in 2005. (No detailed data is yet available to confirm this report). The primary fiscal surplus decreased 31% y-o-y. The BCRA consensus forecasts an ARP 22.3 billion (or 3.5% of GDP) primary fiscal surplus for 2006.

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Planning Minister De Vido delays negotiations with Bolivia on gas prices.
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¶3. On May 18, a spokesman from the Ministry of Planning stated that Minister Julio De Vido had postponed his trip to Bolivia to negotiate the price at which Bolivia will export gas to Argentina. The Minister's trip had originally been scheduled for May ¶16. No further details were provided as to when the Minister will travel, and no further information was provided on the status of negotiations. Argentina currently imports 5% of its gas consumption from

Bolivia at a "solidarity" price of USD 3.20 per million cubic meters, while the international price ranges from USD 2.00 to USD 8.00 per million cubic meters. According to reports, the Bolivian government wants a 65% increase to more than USD 5 per million cubic meters the price of gas.

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Congress approves the creation of the state-owned water company AYSA.
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¶4. On May 17, the Senate ratified a presidential decree approving the creation of the state-owned water company AYSA (Agua y Saneamientos Argentinos SA). The bill received 37 positive votes, 18 negative ones and one abstention. [The Chamber of Deputies approved the creation of AYSA at the beginning of April.] AYSA had been providing water and sewage services to the city of Buenos Aires and fourteen suburban areas of the province of Buenos Aires since March, when the GOA rescinded Aguas Argentinas' concession contract. According to the decree, 90 percent of AYSA's stock will belong to the GOA, while the remaining 10 percent will be given to AYSA's employees union. The company will have an initial capital of ARP 150 million and will be managed by the Ministry of Planning, which also will be responsible for designating its board of directors.

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GOA sends a bill to Congress to modify UIF's structure.
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¶5. On May 16, the GOA sent a bill to Congress that would modify the structure of the Argentine financial intelligence unit (UIF). Highlights of the bill include:
- The UIF will be run by a President and Vice-President, who will be selected by the President and

confirmed under the same process as a Supreme Court Justice, including public comment and disclosure. According to media reports, Abel Fleitas Ortiz de Rozas, the current head of the Anti-Corruption Office, will be the GOA's candidate for President of the UIF.
- The UIF will have a Council of Advisors, who will represent 7 GOA agencies including the Central Bank, AFIP, SEDRONAR, Ministry of Justice, Ministry of Economy, Ministry of Interior, and Stock Exchange Commission;
- The UIF President will make all decisions, after consulting with the Council of Advisors, but he does not need to accept their advice;

¶6. We expect that the bill will be approved without major opposition. However, there are several other similar or related bills pending or about to be introduced, including some that would make terrorism finance a crime, so it is possible that this bill will be amended or merged into a larger bill. The UIF currently is operating with only one of its five directors in place.

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Wheat exporters agree to limit exports to supply the domestic market and avoid price increases.
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¶7. On May 18, local media reported that the GOA was considering a 30-day freeze on wheat export permits -- similar to the 180-day meat export ban implemented at the end of March -- to avoid domestic price increases in bread and flour and thus keep inflation under control. However, Chief of Cabinet Alberto Fernandez, denied those rumors later that day. Wheat producers must register any planned exports with the GOA, which has the right to temporarily suspend wheat exports to guarantee domestic needs. The 2005/2006 wheat crop

dropped to 12.5 million tons -- compared to 16.0 million the previous year -- which analysts believe is not sufficient to supply both exports (mainly to Brazil) and domestic demand. The slide in wheat production was partially caused by drought weather conditions, as well as the increasing switch to soybeans, a lower cost/more profitable crop. Argentina exported 8.7 million tons of wheat in 2005. Exports this year (to May 15) were 3.3 million tons.

¶8. After a meeting with the Minister of Economy Miceli on May 18, representatives from the cereal export association and the flour miller association committed to supply the domestic market with 5.5 million tons of wheat this year, which should be sufficient to guarantee that domestic flour prices remain unchanged.

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March monthly economic activity index up 7.7 percent y-o-y - weaker than expected.
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¶9. The monthly economic activity index increased 7.7 percent y-o-y in March -- well below the BCRA market survey forecast of 8.6 percent. This was the weakest growth rate in the past eight months, and was a sharp deceleration from the 9.5 percent increase in February. However, the index is 37 percent above its low point in the first quarter of 2003 and 9.8 percent above its pre-crisis high, in the second quarter of 1998. The growth in the index came from a 7.2 increase in goods (mainly from industry and construction) and an 8.5 percent increase in the service sector (mainly from the financial sector). The index increased 0.1 percent m-o-m. The latest BCRA consensus survey estimates 7.6 percent economic activity growth for 2006, a downward revision from its previous forecast of 8.6 percent. The monthly

economic activity index is viewed as a reliable leading indicator of GDP.

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Unemployment fell 1.6 percent y-o-y to 11.4 percent in the first quarter, but increased q-o-q.
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¶10. The GOA announced that the unemployment rate dropped 1.6 percentage points y-o-y to 11.4 percent in the first quarter of 2006. However, unemployment increased 1.3 percentage points q-o-q from 10.1 percent in Q4 2005 due to seasonal factors. According to the GOA survey, a total of 1.2 million people are unemployed out of a workforce of 10.8 million. Excluding participants in the Head of Households income supplement plan, the unemployment rate stood at 14.1 percent, versus 12.7 percent in the fourth quarter of 2005. The GOA projects that unemployment will be below 10 percent at the end of 2006.

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April industrial production index up 7.7 percent y-o-y.
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¶11. Industrial production index increased 7.7 percent y-o-y in April, slightly above market expectations of 7.4 percent and a slight acceleration following a 7.5 percent increase in March. During April, the fastest growing sectors were car production (+21 percent), non metallic minerals (+17 percent), oil refining (+13 percent) and chemicals (+11 percent). There was a slight decrease in paper and cardboard, which fell 2.2 percent. The index decreased 2.1 percent m-o-m without seasonal adjustment and increased 0.3 percent m-o-m when seasonally adjusted. The BCRA consensus survey forecasts 6.8 percent industrial production growth for 2006 -- unchanged from last month's

forecast.

¶12. The industry-wide capacity utilization index reached 71.6 percent in April, up 0.3 compared to 71.3 percent in April 2005. The sectors with the highest capacity utilization rates were metal-based industries (96 percent), oil refining (93.9 percent) and textiles (83.6 percent). The sectors with the lowest capacity utilization rates were auto production (50.6 percent), tobacco production (60.1 percent) and minerals (62.6 percent).

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GOA beef export ban has caused USD 180 million in losses.
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¶13. According to the meat industry, the export ban has caused USD 180 million in losses since it was implemented at the end of March. The sector estimates that if the ban remains in effect until September (when the ban is scheduled to end), losses may exceed USD 600 million, including USD 60 million from contracts that were broken by GOA delays in issuing permits for exports to the European Union under the Hilton quota and for other products sold before the ban went into effect, even though both were exempt from the ban. Chief of Cabinet Alberto Fernandez recently reiterated the GOA's position that the export ban will remain in effect until domestic beef prices stabilize. The export ban has also forced slaughterhouses to lay off thousands of workers.

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GOA warns oil companies to invest or lose their concessions.

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¶14. On May 16, the Energy Secretary, Daniel Cameron warned oil executives that the GOA will withdraw concessions on oil fields where companies are not exploring. The hydrocarbons law (N 17.319) establishes minimum investments for oil fields, including requirements to explore fields covered by the concession. In January, the Energy Secretariat issued a resolution requiring companies to submit detailed exploration reports for 2005 and the first half of 2006. The GOA will withdraw concession from companies that do not invest or reallocate those concessions to other companies who are willing to invest. Oil and gas production dropped 5 percent and 1.4 percent, respectively, in 2005 and reserve estimates have fallen to 10 years of supply.

¶15. On May 18, Cronista reported that oil producer provinces -- especially Neuquen the largest oil and gas producer province -- envision that cancelled concessions will be transferred to the provincial government instead of to the federal government.

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BCRA increases repo rates by 0.50 percent.
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¶16. The BCRA announced a 0.5 percent increase in its repo lending rates, bringing its active lending rate to 7.50 percent (rate at which the BCRA offers financing and adds liquidity to the system) and its passive rates to 5.00 percent for one-day and to 5.50 percent for seven days (rates at which the BCRA borrows funds and absorbs liquidity). According to BCRA officials, this increase in the repo rates will not generate an increase in the cost of credit for individuals and enterprises. This is the first increase in passive repo rates and the second increase for active repo rates since the beginning of the year, and it continues the current upward trend in domestic market interest rates.

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BCRA may sell its Boden 2011 holdings to sterilize its intervention in the foreign exchange market.
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¶17. In an interview on May 12, Central Bank President Martin Redrado said that the BCRA may sell its holdings of Boden 2011 to supplement the BCRA's absorption capacity. The Boden 2011 is a peso-denominated bond adjusted by CER (CPI-linked index) with a 3.5 percent coupon. The BCRA received ARP 6 billion of these bonds from the GOA in compensation for its repurchase of provincial quasi-monies in 2003, and is the only holder of this bond. Some analysts have argued that the BCRA may have problems containing the money supply this year as the BCRA continues its policy of rebuilding reserves. However, Redrado downplayed any concerns about the BCRA having difficulty sterilizing the pesos it emits when as it intervenes in the FX market.

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BCRA rolls over its maturities and increases rates for some of its Lebacs.
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¶18. The BCRA received ARP 1 billion in bids at its May 16 Lebac and Nobac auction, compared to the ARP 800 million in Lebacs that came due during the week. Lebac accepted bids totaled ARP 667 million representing 84 percent of the total, with Nobac bids accepted for the remaining 16 percent. The yield on the 28-day Lebac increased 25 basis points from 6.50 percent to 6.75 percent, while the yield on the 63-day

Lebac decreased slightly from 6.86 percent to 6.80 percent and the yield on the 84-day Lebac increased from 7.00 percent to 7.15 percent. The yield on the longest term instrument, the 280-day Lebac, was in 10.20 percent. Lebacs for maturities of more than 280-day were withdrawn due to lack of interest. The spread on the one-year Nobac decreased from 2.16 percent to 2.14 percent, while the two-year Nobac remained in 3.39 percent. The Badlar rate (the base rate for Nobacs) is currently at 8.9 percent.

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Banks present profits of ARP 225 million in the first quarter of 2006.
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¶19. Several banks listed on the Buenos Aires stock exchange presented their balances for the first quarter of 2006. Most reported profits, including Banco Patagonia (ARP 76 million, up 216 percent), Banco Macro Bansud (ARP 73 million, up 20.3 percent), Banco Frances (ARP 41 million, up 26.2 percent) and Banco Hipotecario (ARP 64 million, up 27 percent). However, Banco Galicia reported losses of ARP 29 million, compared to a profit of ARP 17 million in the previous quarter. Galicia's negative results were primarily produced by its decision to accelerate its discount lending repayments to the BCRA.

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GOA reportedly will delay gas tariffs increase for industrial and commercial users until next year.
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¶20. On May 16, local media reported that the GOA will delay gas tariff increases for industrial and commercial users supplied by Gas Ban -- one of the main providers of natural gas in the city of Buenos Aires -- until 2007. This delay comes despite an April 10 decree that authorized a 15 percent average tariff increase for Gas Ban customers (including commercial, industrial and residential consumers). The same day that the decree was published in the Official Gazette, a spokesman for the Ministry of

Planning said that tariff increases for residential consumers would not go into effect until 2007, despite the published decree. Now it appears that gas tariff increase will not go into effect for industrial and commercial users either. Local experts also predict that the Argentine government will be reluctant accede to tariff increases in 2007, an election year.

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Business sector reacts negatively to labor reforms.
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¶21. On May 18, business sector representatives (including the banking, supermarket, commerce, food, rural transportation and industrial sectors) met with deputies from the Labor Committee to voice their concerns about changes to labor legislation that are being considered in Congress. The business sector has two major concerns: (1) an amendment to article 66 of the Labor Law that would define an employee as being fired if the employer changes his labor conditions without his prior agreement, and (2) a bill that would eliminate the maximum threshold for severance pay in case of layoffs. After the meeting, the business associations jointly issued a press release saying that these proposed changes would negatively affect employment rates and economic activity.

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Consumer Confidence Index up 5.1 percent m-o-m.
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¶22. The consumer confidence index -- measured by

Torcuato Di Tella University -- increased 5.1 percent m-o-m in May to 56.8 points, from 54.0 points in April. Two of the three index components increased: consumer willingness to purchase durable goods and real estate (+15.3 percent m-o-m) and personal situation (+4.0 percent m-o-m). There was a slight decrease in the third component of the index -- consumer sentiment towards the macroeconomic environment -- down -0.7 percent m-o-m. The index increased 3.3 percent in the first five months of 2006 compared to the same period last year and 10.4 percent y-o-y. The index is based on surveys of individual economic sentiment and consumer willingness to purchase durable goods, houses and cars.

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The peso depreciated 0.3 percent against the USD this week, closing at 3.07 ARP/USD.

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¶23. The peso depreciated 0.3 percent versus the USD, during this week, closing at 3.07 ARP/USD -- one cent higher than last Friday's close. The peso's depreciation this week is attributed to the BCRA's intervention in the foreign exchange market as well as higher private demand for dollars due to rumors about a wheat export ban (see story above) and some contagion effect from international markets. The BCRA purchased USD 323 million in the FX market in the first four days of the week, a daily average of USD 80 million and lower than the daily average of USD 102 million during the first three weeks of May. The peso exchange rate has depreciated 0.7 percent since the beginning of the calendar year. The BCRA's reserves now (as of May 16) stand at USD 23.9 billion, and have increased USD 5.4 billion, or 29 percent, since the GOA prepaid all of its IMF debt on January 2.

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Commentary of the Week: "Obstacles to the 'Argentine Miracle", by Miguel Angel Broda from an article published in La Nacion on May 14

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¶24. Argentina's economic indicators have turned in a spectacular performance, with 17 consecutive quarters

of recovery. The cumulative GDP increase during that time was 39 percent, driven by domestic demand, which rose 47 percent; it is confirmed by the 43 percent increase in the volume of exports and the 163 percent increase in imports, while industrial production has increased 53 percent and construction 122 percent. Furthermore, growth for this year is expected to exceed 7.6 percent.

¶25. There are various factors that explain this strong recovery:

- An extraordinary external context, with the world growing above its historic average rate for the fourth year in a row, and with favorable terms of trade that could stay in place for the long term due to the insertion of China and India in the international scene as major consumers of primary materials;

- The "technical bounce" that occurs after any collapse; and

- Correct macroeconomic management by this government. On one side, the authorities have produced a high fiscal surplus and sensibly reduced financial obligations for the next few years in the debt restructuring. On the other side, they have produced a high surplus in the current account by maintaining a high and competitive exchange rate. Thus, the country has experienced an unheard of three consecutive years of twin surpluses (fiscal and current).

¶26. Because of this, and in contrast to what has happened in the past, Argentina today is not on the verge of any sort of macroeconomic explosion, nor any irreversible crisis. In fact, it is in quite the opposite situation. The Government has the opportunity to reach an "Argentine miracle." But there are at least three obstacles to the country reaching a high and sustained growth rate.

¶27. First, investment is insufficient. Without a doubt, the increase in gross investment has been impressive, increasing from 11 percent of GDP in 2002 to 22 percent today. However, looking at the functional linkage between the level o investment and growth in the economy, investment is still insufficient to sustain a robust rate of growth. In reality, if we deduct depreciation of the stock of capital of the economy (13 percent of GDP) from gross investment (22 percent of GDP), we are left with a net investment figure (increase in the stock of capital) of 9 percent of GDP. This flow of investment has a productivity (marginal and average) of approximately 0.4 (i.e., each 1 percent increase in net investment produces a 0.4 percent increase in GDP or, inversely, the ratio of capital to production is 2.5). Clearly, by investing 22 percent of GDP, we can grow at 3.6 percent ((22-13) x 0.4). However, to grow 6 percent per year, we would need to invest no less than 28 percent of GDP. In short, we are about 6 percentage points of GDP short of what we need to grow at a significant pace (5-6 percent per year), and we are particularly lacking investments by large companies, in public service companies, and foreign direct investment.

¶28. Concerning investment in privatized public utilities, the 2001-02 crisis required the breaking of contracts and the pesification and freezing of tariffs. Four years later, since we still have not created a new regulatory framework, the companies have no other choice but to limit their investments. The sector today has an inefficient division: old investments with sunk capital and frozen tariffs run by the privatized contract holders, while new investment is being made by the Government, using money from fiduciary trust funds that receive special tax and surcharge revenues. This Argentine invention

has all of its incentives backwards. The private concession holders don't invest due to the lack of profitability and the risk of an "Evo-ization," while the State does everything at a much higher cost and over a longer period of time. It will be very difficult to improve the productivity of capital and increase investment with this system of perverse incentives in place.

¶29. Concerning foreign direct investment, Argentina's share of the total flow of foreign direct investment into Latin America is falling, totaling just 6 percent of the total versus 14 percent in 1996-2000. Furthermore, only a fraction -- 13 percent -- of the profits generated from this investment is being re-invested, compared to 30 percent in 1996-2000.

¶30. This lack of significant national or foreign investment is due to the government's excessive intervention in the market, the volatility of the rules of the game, and the lack of judicial security, all of which prevent a predictable investment horizon. The response of the Government to this lack of investment has been to revive the archaic idea of the State's supplementary role as a substitute for private investment. The State, instead of planning and directly making the needed investments, should create the conditions needed to attract private investment that would produce a qualitative leap in productivity

and thereby consolidate the strong quantitative growth of the last few years.

¶31. Secondly, a number of microeconomic distortions are accumulating. Particularly worrisome is the use of the price system and trade policy as anti-inflationary tools. The current system of "political" prices and subsidies is perverse because it stimulates demand and reduces supply, making what is scarce cheap and what is abundant, expensive. These price distortions no longer fulfill their role reflecting the relative scarcity of goods and inputs, creating disequilibria between supply and demand, disinvestment and poor allocation of resources, damaging long-term growth prospects.

¶32. Lastly, the Argentine State itself is an obstacle. Countries that have reached high and sustained levels of growth have governments that: (1) work from an strategic plan and don't try for short-term political gains that detract from their long-term objectives; (2) stimulate social mobility by promoting equality of opportunity in the education system, rewarding hard-work, merit and innovation; (3) increase their investment in research and development; (4) work actively to obtain greater openness of foreign markets and to generate externalities for the development of productive clusters; and (5) create the mechanisms for the efficient use of resources and increases in productivity. Unfortunately, the Argentine State has caused considerable delays in all of these areas.

¶33. In conclusion, given the unbeatable external environment and the macro stability it has reached, Argentina has the possibility of a brilliant future, after 30 years of mistakes. Nevertheless, due to the economic policy of the current government, the country faces significant barriers to reaching the "Argentine miracle." I hope I am mistaken. (Note: We reproduce selected articles by local experts for the benefit of our readers. The opinions expressed are those of the authors, not of the Embassy. End Note.)

GUTIERREZ